

Asset Class Glossary: Fixed Income
Policy: Credit Enhancement Program
~~February 14, 2005~~ June 16, 2006

Amendment Fee

A fee charged by an underwriter or a group of underwriters for any amendment(s) to the Credit Instrument (Letter of Credit/Line of Credit), Reimbursement Agreement or Trust Indenture.

Annual Commitment Fee

A fee charged by an underwriter or a group of underwriters covering the period from commitment to defeasance.

Authority or Agency

A state or local unit of government created to perform a single activity or a limited group of functions and authorized by the state legislature to issue bonded debt.

Bond

A unit of debt, \$1,000 of principal or par amount. For 200 years municipal bonds were sold in \$1,000 denominations. Since the mid-1970s the minimum bond denomination has been \$5,000; nevertheless, "A Bond" is bought, sold, referred to, and priced as if it were \$1,000.

Certificates of Participation (COP)

A form of lease revenue bond that permits the investor to participate in a stream of lease payments, installment payments, or loan payments relating to the acquisition or construction of specific equipment, land, or facilities. In theory, the certificate holder could foreclose on the equipment or facility financed in the event of default, but so far no investor has ended up owning a piece of a school house or a storm drainage system. A very popular financing device in California since Proposition 13, because COP issuance does not require voter approval. A COP is not viewed legally as "debt" because payment is tied to an annual appropriation by the government body. As a result, a COP is seen by investors as providing weaker security and often carry ratings that are a notch or two below an agency's general obligation rating.

Chief Investment Officer

Heads the CalPERS Investment Office and works with the Investment Committee to develop a long-term investment policy and asset allocation strategy for the Public Employees' Retirement Fund.

Credit Enhancement

The term is used in context of CalPERS Credit Enhancement Program (CEP). It refers to instruments whereby CalPERS' CEP credit rating is used to strengthen the credit rating of a lower-rated entity in bond or note financing transaction through either liquidity (e.g. standby bond or note purchase agreements, lines of credit) or credit guarantees or both liquidity and credit guarantees (e.g. letters of credit). Through the use of these

instruments CalPERS' CEP credit rating is substituted for that of a lower rated entity in exchange for a fee. Such enhancements become a contingent liability upon CalPERS' overall balance sheet.

Credit Rating

A current opinion of an obligor's overall financial capacity (its creditworthiness) to pay its financial obligations. This opinion focuses on the obligor's capacity and willingness to meet its financial commitments as they come due. In the case of split ratings, the higher rating of either Moody's, Standard & Poor's, or Fitch Investor Services shall apply.

Deal Originator

~~A bank or other financial institution who has entered into a Strategic Relationship contract with CalPERS' to participate in the credit enhancement program.~~

Debt Limit

The maximum statutory or constitutional amount of debt that the general obligation bond issuer can either issue or have outstanding at any time.

Default

Failure to pay in a timely manner principal and/or interest when due, or a Technical Default, the occurrence of an event as stipulated in the Indenture of Trust resulting in an abrogation of that agreement. A Technical Default can be a warning sign that a default on debt service is coming, but in reality actual debt service interruption does not always occur if the problems are resolved in time. A Technical Default will almost always drive down the price of a bond in secondary market trading.

Direct State Government Issued Debt

Any bond or security directly issued by state governments (voter or non-voter approved), including but not limited to, General Obligation debt, Tax and Revenue Anticipation Notes, Tax Anticipation Notes, Revenue Anticipation Warrants, and Revenue Anticipation Notes. Where the state has taken over the underlying municipal government finances, such issuer automatically acquires implicit/explicit state-level support, and this will count towards the direct state government issued debt limit.

Essential Municipal Services

Those municipal services including, but not limited to, water, power, sewer, garbage removal, and other infrastructure essential to the well being and quality of life of a municipality, and upon which the municipality pays a high priority in service delivery.

Financial Partners

A financial institution (public or private) that collects funds (from the public or other institutions and invests them in financial assets.

Fitch Ratings

A nationally-recognized credit rating agency that grades the investment quality of bonds in a 10-symbol system. The ranges extend from the highest investment quality, which is

AAA, to the lowest credit rating, which is D. Securities rated BBB- or greater are considered investment-grade. Securities rated BB+ or below are considered to be speculative.

General Obligation Bond

A bond secured by a pledge of the issuer's taxing powers (limited or unlimited). More commonly the general obligation bonds of local governments are paid from ad valorem property taxes and other general revenues. Considered the most secure of all municipal debt. Limited in California by Proposition 13 to debt authorized by a vote of two-thirds of voters in the case of local governments or a simple majority for State issuance.

General Pension Fund Consultant

An individual or organization that provides specialized professional assistance to the CalPERS Board of Administration in determining the pension fund's asset allocation model or optimal combination of investments in order to maximize risk-adjusted investment returns in a manner consistent with the State's long-term pension liabilities.

Industrial Development Bonds

Also called Industrial Revenue Bonds. Used to finance facilities for private enterprises, water and air pollution control, ports, airports, resource-recovery plants, and housing, among others. The bonds are backed by the credit of the private corporation borrower rather than by the credit of the issuer. Also known as Conduit Bonds. Private purpose bonds are limited by federal law to \$50 times the state's population on an annual basis.

Investment Grade

A minimum credit rating of Baa3 by Moody's Investor Service or BBB- for Standard & Poor's Corporation, and BBB- by Fitch. Investment grade ratings apply to issuers whose financial risk is relatively low and the probability of future payment relatively high.

Irrevocable

A binding and irreversible commitment.

Issuer

A state or local unit of government that borrows money through the sale of bonds and/or notes.

Letter of Credit

A form of supplement or, in some cases, direct security for a municipal bond, under which a commercial bank or private corporation guarantees payment on the bond under certain specified conditions. The legal obligation to fund these instruments is "unconditional" (irreversible instrument).

Lines of Credit

These are also referred to as Standby Bond or Note Purchase Agreements and Liquidity Lines. These are designed to provide liquidity (as opposed to credit

enhancement) in the event of financial market disruption. The legal obligation to fund under these instruments is "conditional" (revocable instruments).

Liquidity Lines

See Lines of Credit.

Moody's Investors Service

A nationally-recognized credit rating agency that grades the investment quality of bonds in a 9-symbol system. The ranges extend from the highest investment quality, which is Aaa, to the lowest credit rating, which is C. Securities rated Baa3 or greater are considered investment grade. Securities rated Ba1 or below are considered to be speculative.

Municipal Bond

Bonds issued by any of the 50 states, the territories and their subdivisions, counties, cities, towns, villages and school districts, agencies (such as authorities and special districts created by the states), and certain federally-sponsored agencies (such as local housing authorities). There are two broad groups of municipals: 1) Public Purpose bonds, which remain tax-exempt and can be issued without limitation; and (2) Private Purpose Bonds, which are taxable unless specifically exempted.

Nationally Recognized Credit Rating Agencies

See Moody's, Standard and Poor's, and Fitch.

Non Profit 501(c)(3) Institutions

These are institutions exempt from federal, and in some cases, state income tax.

Note Purchase Agreement

A formal agreement between the issuer of the bonds and the purchaser of bonds that describes the terms and conditions applicable to the bond.

Notes

Intermediate-term, interest-bearing instruments issued by corporations, municipalities, or the federal government with maturities commonly ranging from five to 12 years.

~~Pre-Fund~~

~~The ability to prepay any draws by the trustee on the Credit Instrument (Letter of Credit/Line of Credit) on behalf of CalPERS.~~

Primary Obligor

The entity directly responsible for making interest and principal payments on an outstanding obligation. Investors will look to a secondary obligor (i.e., credit enhancer, fronting bank, etc.) should the primary obligor fail to make these payments.

Prudence Certificate

The prudence certificate includes (1) signatures of the investment officers or portfolio

managers involved in reviewing the transaction; (2) their verification that the credit enhancement is a prudent use of CalPERS funds and that the transaction has been made with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting on a like capacity and familiar with those matters would make; (3) verification that the transaction does not constitute a prohibited transaction within the meaning of the California Public Employees' Retirement Law (constituting Article XVI, Section 17 of the California Constitution); and (4) verification that the staff is unaware of any fees, compensation, agreements, or arrangements constituting a conflict of interest under the California Public Employees' Retirement Law (constituting Article XVI, Section 17 of the California Constitution) with respect to any member of the Board or any of the CalPERS employees or internal investment contractors.

Rating Category Determination Letter

Privately-issued alphabetical and numerical designations issued by the credit rating agencies to give relative indications of non-publicly rated bond and note creditworthiness.

Ratings

Various alphabetical and numerical designations used by institutional investors, Wall Street underwriters, and commercial rating companies to give relative indications of bond and note creditworthiness. Standard & Poor's and Fitch use the same system, starting with their highest rating of AAA, AA, A, BBB, BB, B, CCC, CC, C, and D for default. Moody's Investors Services uses Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C, and D. Each of the services use + or - or +1 to indicate half steps in between. The top four grades are considered investment grade ratings.

~~Risk Participation Agreement~~

~~An agreement between CalPERS and the Service Agent, or approved Deal Originators, obligating the Service Agent, or approved Deal Originators, to participate in every approved transaction at a minimum of an equal amount of investment with CalPERS.~~

Safe Harbor Rules (IRC 503(e))

Restricts investments to no more than 25 percent in any transaction involving the plan sponsor.

~~SAS 70 Audit Report~~

~~Relates to an annual examination by an outside auditor of risk controls placed in operation by a financial institution or bank and tests of operating effectiveness of those controls.~~

Security

Instrument that signifies an ownership position in a corporation (stock), a creditor relationship with a corporation or governmental body (bond), or rights to ownership such as those represented by an option, subscription right, and subscription warrant.

Senior Investment Officer of Fixed Income

The senior investment officer is responsible for all fixed income and reports to the chief investment officer of CalPERS.

Service Agent

~~A qualified institution that will provide comprehensive day-to-day operational and recordkeeping services to the program, as well as provide a Memorandum of Issuance for all potential new and approved transactions. Service Agent may from time to time participate in an approved credit enhancement transaction, and if it does so participate, whether by invitation or otherwise, it must commit to be a Plan fiduciary if so requested by staff. Service Agent will service all approved credit enhancement transactions.~~

Special Assessment Bond

A bond secured by a compulsory levy of special assessments, as opposed to property taxes, made by a local unit of government on certain properties to defray the cost of local improvements and/or services that represents the specific benefit to the property owner derived from the improvement. In California, these are usually 1915 Act or 1911 Act Bonds.

Special Assessment Districts

Special assessment districts may be initiated: 1) either through a resolution by city council; or 2) at the request of a property owner whose property would be included in the district to be assessed. Such districts describe a method of financing public improvements by distributing the cost of a project over those property owners who will reap a direct benefit. The types of local public improvements that are most often paid for through special assessments include sanitary sewers, storm drains, water mains, road paving, dust control, sidewalk construction, and street lighting.

Split Rated Security

A security that has a different credit classification by two rating agencies. For the purpose of this policy, a security is called a split-rated security, if Standard & Poor's and Moody's report a difference in the ratings.

Stand By Purchase Agreement

See Lines of Credit.

Standard & Poor's

A nationally-recognized credit rating agency that grades the investment quality of bonds in a 10-symbol system. The ranges extend from the highest investment quality, which is AAA, to the lowest credit rating, which is D. Securities rated BBB- or greater are considered investment grade. Securities rated BB+ or below are considered speculative.

Trustee

A bank designated as the custodian of funds and official representative of bondholders.

Trustees are appointed to ensure compliance with the trust indenture and represents bondholders to enforce their contract with the issuer.

Up Front Closing Fee

A fee paid up-front by an issuer to an underwriter or a group of underwriters, which agrees to purchase an entire security issue for a specified price, usually for resale to others.

Variable Rate Bond

A bond whose yield is not fixed but is adjusted periodically according to a prescribed formula.

Waiver Fee

A fee paid by an issuer to an underwriter or a group of underwriters to waive any requirement of the Credit Instrument (Letter of Credit), Reimbursement Agreement, or Trust Indenture.